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RHEBAAA/DEPT OF ENERGY WASHDC

C O N F I D E N T I A L PRAGUE 001232

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STATE FOR EUR/NCE, EUR/ERA, EB/ESC

E.O. 12958: DECL: 10/19/2017
TAGS: ENRG ECON EINV PREL EZ
SUBJECT: CZECH-HUNGARIAN ENERGY JOINT VENTURE: POTENTIAL
BENEFITS AND RISKS

REF: A. PRAGUE 992

¶B. BUDAPEST 1618
¶C. BUDAPEST 1413
¶D. BUDAPEAT 1134

Classified By: Pol-Econ Counselor Mike Dodman
for Reasons 1.4 B+D.

¶1. (U) This is a joint cable by Embassy Prague and Embassy Budapest.

¶2. (C) SUMMARY AND CONCLUSION: The proposed joint venture between Czech electricity giant CEZ and Hungarian energy group MOL is a deal driven by business interests -- CEZ's desire to get its foot in the door in Hungary as a regional hub and at least in part by MOL's desire to consolidate its power in the Hungarian market. Energy security in the geo-political sense does not appear to be part of the decision making matrix in Prague, although the defense from further Russian encorachment featured prominently in MOL's rationale for the deal. Regardless, the partnership is likely to have implications for future european energy security. Negotiations between these two publicly-listed companies are on-going and CEZ hopes they will be concluded by end-2007. Despite the lack of details on the proposed venture, there is press speculation that political consideration to keep Russian interests out of Central Europe is overriding business interests. CEZ believes these speculations are fueled by those who will lose out from this deal -- the Russians and the Austrians. END SUMMARY AND CONCLUSION.

¶3. (U) Czech electricity giant CEZ announced on August 30 that it is in negotiations with Hungarian oil, gas and petrochemicals group MOL to build two gas-fired power plants in Slovakia and Hungary. According to its press release, as part of the joint venture, MOL would provide CEZ with needed future gas supplies and CEZ would buy up to a 10% equity stake in MOL. The pending deal has come under criticism and scrutiny in the press based on speculation that the deal is motivated by MOL's efforts to stave off OMV's hostile take-over bid, which, according to MOL, is being undertaken in conjunction with Russian giant Gazprom. Observers have especially criticized CEZQking a 10% equity stake in MOL saying it does not make economic sense, is too risky and is politically motivated.

CEZ BUSINESS LOGIC AND RISKS

¶4. (C) According to CEZ Director of Mergers and Acquisitions

Vladimir Schmalz (please protect), MOL has refineries in Hungary and Slovakia with insufficient electricity generation capacity to meet future demand. The joint venture, therefore, is based on a framework that MOL will provide the infrastructure and the gas supply while CEZ will provide the technology and the resources to increase the capacity at both brownfield sites. He put this business logic in the context of CEZ regional expansion strategy, explaining that despite its surplus capacity, CEZ has limited opportunities to enter the electricity generation market in neighboring Austria or Slovakia given OMV's dominant position in Austria and ENA's in Slovakia. In the meantime, Hungary is now the regional hub for any energy company seeking to expand into southeast Europe and the proposed deal with MOL provides CEZ with the strategically important opportunity to get in to Hungary as well as into Slovakia. Therefore, CEZ sees the much-criticized 10% stake in MOL as the required "entry ticket." Schmalz added that it is in the interest of both companies for the deal to be concluded as soon as possible given its destabilizing effect on the capital markets due to on-going speculation.

¶5. (C) Schmalz conceded that a secure gas supply from MOL presents the greatest risk to the proposed deal. CEZ has considered this risk and has decided it is worth taking based on the belief that in the future there will be greater diversification and competition in Europe's gas sector. Possible sources of this diversification include new LNG terminal in the Adriatic, Nabucco coming online, and the belief that Russia does not wish to lose its market in Europe. In addition, Schmalz sees great benefits to increasing the use of gas for electricity generation in Europe -- it is environmentally friendly (compared to coal), politically more palatable (compared to nuclear), fast construction (24 - 30 months), and has the best start-up to delivery time (60 seconds vs. hours for coal/nuclear).

NO GOVERNMENT INFLUENCE

¶6. (C) Even though CEZ is 67.44% owned by the Czech government, the government has been consistently "hands-off" on CEZ business decisions. According to Czech Ambassador-at-Large for Energy Security Vaclav Bartuska, the Czech government had no role in either encouraging or discouraging this deal between CEZ and MOL. He emphasized that neither the Czech government nor CEZ would want this deal to happen if it were not profitable to CEZ. Furthermore, Bartuska noted that CEZ's enthusiastic regional expansion (reftel A, para 4) has not yielded the kind of profit CEZ had projected, suggesting that CEZ would be increasingly averse to risky investments abroad and increasingly concerned about the impact of any proposed joint venture on overall corporate profitability. Schmalz acknowledged that CEZ projects in Bulgaria, Romania and Poland are less profitable than projected because governments in all three countries are not upholding the contractually guaranteed profit levels. However, CEZ is profiting nonetheless, which is why it has opted not to sue those governments for breach of contract.

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SAVE US, BUT NOT FROM OURSELVES: WHY MOL WANTS CEZ OVER OMV
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¶7. (U) Over the summer, OMV doubled its equity stake in MOL to roughly 21 percent in an effort to affect a "friendly merger." MOL fiercely rejected OMV,s overture, accusing the Austrian firm of colluding with Gazprom-controlled entities to acquire MOL and sell off key strategic assets (reftels B-D). After a summer of heated rhetoric, OMV announced its hostile bid for MOL.

¶8. (C) According to Chairman and CEO Zsolt Hernadi, MOL sought the CEZ partnership as a "white knight," as the Hungarian oil and gas company bolstered its defenses against

a hostile takeover. Prior to approaching CEZ, MOL sought a similar arrangement with PKN Orlen, but the Polish energy company -- wary of Hungary,s close ties to Russia, according to Embassy Warsaw -- declined a strategic partnership. In addition to questioning the economics of the deal, industry watchers have criticized MOL -- whose public discourse regarding OMV,s efforts emphasized the Austrian government,s stake in the company -- for partnering instead with another majority-state-owned company.

¶9. (C) Except as a defensive maneuver against OMV,s hostile attempts, analysts have said the CEZ-MOL deal brings little to the Hungarian company. An E.ON executive in Budapest noted soon after the MOL-CEZ announcement that the arrangement makes business sense only if MOL -- possibly in conjunction with Emfesz or System Consulting, two companies currently planning to build gas-fired powered plants in eastern Hungary -- seeks to recreate a national champion with gas and power capabilities.

¶10. (C) The same E.ON contact shared in early November closely held information that Emfesz and MOL had signed a cooperation agreement for the former,s planned 2400 MW plant and that OTP Bank -- whose CEO Sandor Csanyi is said to be one of two key decision makers on MOL,s Board -- would provide at least partial financing for the project. Also last week, local newspaper Vilaggazdasag reported that OTP had set up an offshore company in Cyprus, where Emfesz and its parent company RosUkrEnergo (RUE) also have links. Finally, Hungarian authorities have delayed for years the sale of state-owned electricity company MVM, but when the utility is finally sold, a MOL bid -- strengthened by Emfesz and CEZ partnerships -- could portend the creation of a monopoly in Hungary,s electricity sector.

ENHANCED ENERGY SECURITY?

¶11. (C) Though seemingly motivated by business interests, the CEZ-MOL deal could have a lasting impact on European and regional energy security. In the Czech Republic -- where coal-fired power plants produce around two thirds and nuclear power accounts for about a quarter of electricity production -- gas is considered an untapped potential future source. However, MOL's dependence on Russia and Ukraine for gas could introduce additional vulnerabilities for the Czech Republic.

For Hungary, the government,s strong bipartisan support for all manner of defenses against OMV in the short term may have created fertile ground for a homegrown energy monopoly in the longer term. The GOH,s and the EU,s handling of the CEZ-MOL deal, as well as legislation aimed at protecting strategic industries (e.g., "Lex MOL"), will determine the extent to which the Czech-Hungarian energy partnership could have larger implications.
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